

FCA symposium: competition analysis with realistic behaviour

Read our summary of the insights, research and opinions of the main speakers at the FCA symposium on Behavioural Industrial Organisation, held in December 2015.

These points reflect the independent views of the speakers and do not represent the views of the FCA, which facilitated the event.

Introduction

Promoting effective competition in financial markets is essential to improving value to customers, with firms competing on service, quality, price and innovation.

We know customers can find it particularly difficult to engage with financial services markets, in part because financial products are often highly complex. When taking into account the complexity of products and the customer behaviour, the standard lessons of competition analysis need refining.

Economists have today made welcome strides forward, with academic progress centred on competition analysis with realistic behaviour – known as Behavioural Industrial Organisation (BIO).

Essentially a chemistry of competition and behavioural economics, BIO draws on classic competition theory but relaxes assumptions around the logical consistency of human behaviour and decision-making.

For economists, this offers an important opportunity to understand the relationship between behavioural biases – including the emotional, social, cognitive and psychological factors that frame our economic decision making – and classic market failures such as market power, information asymmetries and externalities.

For regulators and competition authorities, BIO in turn provides a potentially rich opportunity to test interventions in a ‘real world’ context, equipping them with a better understanding of financial markets and a more realistic context upon which to base critical decisions.

In a symposium held in December last year, the FCA welcomed senior thinkers, researchers and policy makers from around the world to discuss this increasingly important work.

This report collates some of the insights, research and opinions put forward by our speakers at the conference. We would like to thank everyone who attended and contributed to the day's discussions.

Executive summary

Much has been made of the potential impact of Behavioural Economics on policy making over the last decade. Few areas, however, have attracted more attention than financial services, where we know the quirks of human decision making can have a particularly pronounced impact.

Behavioural Industrial Organisation is an important attempt to understand how such biases interact with classical market failures and affect market equilibrium and dynamics. Understanding how these failures interact, compete and conflict with each other is an imperative in order for regulators and other policy makers to design effective competition remedies and avoid unintended consequences resulting from regulation.

As a number of contributors at the symposium commented, BIO also challenges some long cherished beliefs. One of the most important being the assumption that the more players you have in a market, the more competitive it is. This, as David Laibson points out, can be an illusion in a market where the demand-side often struggles to reward the best companies and punish the worst.

Other important themes highlighted during the day – by speakers including Michael Grubb, Ran Spiegler and Amelia Fletcher – were overconfidence among consumers, choice complexity and cross-market interventions, whilst a number of delegates picked out the limitations of disclosure remedies and the importance of having a functioning market for advice.

Finally, there was also a warning from some in the audience that remedies aimed at reducing complexity and increasing the comparability of products come with their own risk. Among them, the danger of a 'one-size-fits-all' approach to the development of products in financial services.

When does competition reduce prices?

David Laibson, Robert I. Goldman Professor of Economics and Chair of the Department of Economics, Harvard University

David Laibson challenged the belief that a higher number of firms in the market is automatically beneficial to competition and therefore to consumers. David argued that when consumers do not know, or cannot assess the price of a product, competition may not work in the way we would expect. An increase in the number of firms in the market does not necessarily reduce prices and, in certain circumstances, firms may have the incentive to increase prices.

David suggested that, if consumers are not able to assess whether a service provides good value for money, firms may not have incentives to compete with rivals, and may prefer to exacerbate confusion in the market. Firms profit from consumers' confusion and do not have incentives to educate consumers.

This confusion, or 'shrouding', can in turn reduce consumers' welfare and possibly lead to cross-subsidies from the confused consumers (who may be vulnerable) to sophisticated consumers.

David also discussed the weaknesses of disclosure. He presented the results of two experiments on mutual funds that suggest that simplified documents that focus on important aspects of the funds (ie, mutual funds fees) have a marginal impact on consumers' choice.

"The usual economic perspective is 'let the invisible hand do its magic' but we need to recognize the limits of that argument and we need to understand the psychological underpinnings of those limits" David Laibson

Overconfident consumers in the marketplace

Michael Grubb, Assistant Professor of Economics, Boston College

Michael Grubb presented his research on the effects of consumers' overconfidence on market outcomes. Expectations about future usage are important when consumers buy a product, as its expected value varies with the expected usage.

For example, the value provided by car insurance for a consumer depends on confidence over their driving abilities and the likelihood of a car accident. If consumers overestimate their driving abilities, they will underestimate the likelihood of an accident and may value the insurance as being of less worth than it actually is.

Consumer overconfidence therefore affects market outcomes. First, firms may have incentives to exploit consumer overconfidence, by introducing complicated pricing features that are sometimes robust to competition.

Second, the welfare consequences for firms and consumers depend on whether overconfident consumers over- or undervalue a product, on market structure, and on the nature of consumer heterogeneity. Competition may fail to protect overconfident consumers, and the presence of sophisticated consumers may exacerbate the resulting harm to overconfident consumers.

Finally, Michael presented his research on the effectiveness of policy interventions and showed that regulators must carefully identify and consider the likely response of the firms to the policy interventions. Once one takes into account firms' reaction, it may turn out that a seemingly effective policy has actually a negative impact on consumers' welfare.

"Behavioural Industrial Organisation means taking standard economic questions about how markets are working making the assumptions realistic and putting real people into the models" Michael Grubb

Choice complexity and market competition

Ran Spiegler, Professor of Economics, Tel Aviv University and University College of London

Ran Spiegler presented his theoretical research on choice complexity and competition – arguing that consumers often find it hard to make value comparisons between market alternatives.

Complexity may be an intrinsic characteristic of a product or a service (especially in the financial services) but part of this choice complexity may be due to deliberate obfuscation by firms. Ran's lecture highlighted the endogenous determination of choice complexity in response to various changes in the market environment, and its effect on consumer welfare.

Ran defined choice complexity as the difficulty that consumers encounter when comparing market alternatives. The relationship between complexity and competition is twofold. On the one side, complexity affects the focus of competition among firms, and on the other side competitive forces affect the endogenous determination of choice complexity.

Finally, Ran focused on the role of consumer protection. Regulatory intervention, eg, regulating product disclosure or designing default options, has an effect on the level of complexity and ultimately on consumer welfare.

Theoretical models suggest that equilibrium obfuscation and choice complexity may increase in response to intensified competition, mitigating the positive effect of competition on consumer welfare.

Behavioural Industrial Organisation: Theory and practical market intervention

Amelia Fletcher, OBE, Professor of Competition Policy, Centre for Competition Policy, University of East Anglia

Amelia Fletcher talked about the interactive role of demand and supply side in a competitive market. She presented competition as a virtuous circle, where suppliers are competing to serve their customers who purchase the product that offers the best value for money. This drives competition and innovation. However, as Amelia argued, this may not work because of traditional market failures and because of consumers' biases. In other words, consumers may not be able to access, assess and act on the information.

Amelia introduced the idea that there may be two categories of Behavioural Industrial Organisation models. In both, consumers exhibit systematic biases when assessing the value of a product. The first category includes those cases where firms may adjust their quantity and price decisions in the face of such biases, but do not actively act to worsen consumer decision-making. The second category includes those cases where firms do act strategically to exacerbate these biases and thus worsen things for consumers still further.

Amelia questioned whether regulators should behave differently when they face one situation or the other. In the first category of models, firms may not be doing anything wrong. In this case, Amelia suggested the regulator should engage only in forward-looking, market-specific interventions. When the regulator faces markets that fall in the second category of models, she asked whether there is scope for cross-market interventions, even in the absence of collusive agreements or abuse of dominant position, so that firms do not engage in practices that exacerbate consumers' biases. Examples of such interventions are the prohibition of drip-pricing (such as payment surcharges for airlines) or the prohibition of opt-out boxes.

"From today's event, I'd like people to have a better understanding of behavioural economics and how it can feed into how we can intervene in markets to make them work competitively in a way that is actually better for consumers" Amelia Fletcher

Economics for effective regulation

Zanna Iscenko, Technical Specialist, Chief Economist's Department, Financial Conduct Authority

Zanna Iscenko presented the FCA Occasional Paper on Economics for effective regulation (EFER).

This paper draws on the recent advances in regulatory practice and economic research, including BIO, to present a market-based approach to regulatory economic analysis. This approach involves a combined assessment of all the main problems that can lead to markets not working well: information asymmetries, externalities, market power, behavioural distortions and unintended consequences of previous interventions.

One of the areas of focus in EFER is supporting the analysis of behaviour of market participants, including their likely responses to regulatory interventions, and interactions between different kinds of problems in the market. As such, EFER attempts to make BIO truly operational in terms of deciding when and how to intervene in order to achieve regulatory objectives and net social benefits.

The paper describes the three stages of EFER – diagnosing problems in the market, designing regulatory interventions and analysing their impacts. It also provides a structured framework and tools to help undertake each stage of the analysis.

Panel discussion: Behavioural Industrial Organisation and its implications for policy interventions

Charlotte Duke, Partner, Behavioural and Experimental Economics team, London Economics

David Laibson, Robert I. Goldman Professor of Economics and Chair of the Department of Economics, Harvard University

Steve Smith, Director, Competition and Regulatory Strategy team, Lloyds Banking Group

Chair:

Fod Barnes, Senior Advisor, Financial Conduct Authority

The panel discussion tackled a wide range of themes and was characterised by a fruitful interaction between the audience and the panel participants, which benefited from the diverse background of the participants.

Firstly, we discussed 'contract hollowing competition', that is, those situations where firms compete on the salient elements of a product and offer poor value on the other elements. Secondly, the debate moved on to how consumers deal with market complexity. We discussed what the regulator can do to improve outcomes for consumers.

All participants recognised the positive impact technology and innovation have had in helping consumers to understand products. It was also reiterated that, even though it is a step in the right direction, disclosure is often a weak remedy though it was noted that disclosure may work well in certain situations. An example is when disclosure tackles information asymmetries and it is directed at market participants who know how to use the information.

Remedies aimed at reducing complexity and increasing product comparability may well help some consumers in picking the right products for them.

Participants also pointed out the risks of a 'one size fits all' approach, where the regulatory framework may not allow firms to adjust their communications to different consumer segments. It was also noted that complexity may not be an outcome that is sought by firms. Firms may not act as rationally as described in the academic models, and may not strategically adjust their behaviour to exacerbate consumers' biases.

Participants were optimistic that experts can help consumers to deal with complexity. They noted that for an advice market to work well, it should be characterised by a lack of conflict of interests and potentially by the legal liability of intermediaries. Participants also mentioned the example of 'safe harbour' as a solution to complexity. Regulators may promote simplicity by allowing some regulatory relief to 'simple' products.